No. 18641

In the United States Court of Appeals for the Ninth Circuit

FOREST G. SMITH, JR., and ROSE MARY SMITH,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

697-048—63——1

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 418–434) are not officially reported.

JURISDICTION

This petition for review (R. 437–439) involves federal income taxes for the taxable years 1954, 1955, and 1956. On April 29, 1960, the Commissioner of Internal Revenue mailed to the taxpayers notice of a deficiency in the total amount of $85,865.67. (R. 12–20.) Within ninety days thereafter and on July 15, 1960, the taxpayers filed a petition with the Tax Court for a redetermination of that deficiency under-

the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 5–20.) The decision of the Tax Court was entered December 13, 1962. (R. 436.) The case is brought to this Court by a petition for review filed March 11, 1963. (R. 437–439.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Did the Tax Court err in finding and holding that taxpayer's sale of the Clock Restaurants took place in 1956?

2. Did the Tax Court err in finding and holding that in the sale of the Clock Restaurants in 1956 taxpayer's indebtedness pertaining to the assets sold was assumed by a solvent purchaser and that the transaction involved the substantial receipt of money and the realization of gain by taxpayer in 1956 under Section 1001 of the Internal Revenue Code of 1954?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra.*

STATEMENT

In 1956, taxpayer [1] owned and operated the Clock Restaurants, a restaurant chain, and also was a general partner in B. D. S. Company, a California limited partnership. The B. D. S. Company held a sublessee's interest in the properties in which the Clock Restaurants were located. These subleases also cov-

[1] Forest G. Smith, Jr., the husband, is referred to hereafter as the taxpayer although his wife is a party since joint income tax returns were filed for the period in issue.

ered some of the restaurant equipment. Prior to 1956, B. D. S. had, in turn, subleased the same premises and equipment to taxpayer, and this sublease was still in effect on October 30, 1956. (R. 419.)

On October 30, 1956, taxpayer and Robert O. Peterson entered into a "Memorandum Agreement" under which taxpayer sold to Peterson the Clock Restaurants and Taxpayer's interest in B. D. S. (hereafter referred to collectively as the Clock Restaurants). (R. 37, 139, 419.) The Memorandum Agreement states with respect to the terms of the sale (R. 420–421, 423):

> (1) Smith does hereby sell, assign and set over to Peterson all of the assets as disclosed by said financial statement with the exception of Exceptions No. 1 and No. 2 [Exception No. 1 refers to an asset designated on the financial statement as "Contracts receivable—B. D. S. Company" in the amount of $333,500 and Exception No. 2 refers to an asset designated as "Accounts receivable—B. D. S. Company re fixed asset acquisition" in the amount of $20,802.16.] Smith does hereby sell, assign and transfer to Peterson all of Smith's right, title and interest, and capital account as a general partner, in and to that certain limited partnership known and designated as B. D. S. Company, subject only to the consent of the general and special partners of said limited partnership to the substitution of Peterson as a general partner in the place and stead of Smith.
>
> (2) Smith does hereby sell, assign, transfer and set over to Peterson all of Smith's right, title and interest as sublessee in and to the

master sublease referred to in the premises on condition that Peterson assume all of the obligations of the master sublessee as therein provided, and on the further condition that the master sublessor consents to said assignment and also on the further condition that Smith be relieved of all obligations and liabilities under said master lease which may hereafter accrue.

(3) Smith does hereby sell, transfer and set over to Peterson all of Smith's right, title, and interest in and to Clock Restaurants Nos. 17, 18, and 19.

(4) Peterson hereby agrees to accept all of the above and foregoing assets referred to in paragraphs (1), (2), and (3) and to pay therefor by taking them subject to the liabilities as shown and disclosed on said financial statement dated September 30, 1956, in the amount of $890,450.17, exclusive of the item designated therein as "Accrued rent payable—B. D. S. Company" in the amount of $305,481.17, thereby reducing the liabilities to $584,969.00, plus liabilities and assets that have been accrued in the normal course of business in the operation of Clock Restaurants by Smith from and after the date of said financial statement to the date that Peterson takes possession of said Clock Restaurants.

(5) Smith does hereby indemnify and save Peterson harmless from any loss or liability by reason of any liabilities of Smith other than those shown and set forth in said financial statement of September 30, 1956, and those incurred in the normal course of the operation of said business from and after the date of said financial statement to the date that Peterson takes

possession of said Clock Restaurants. Any assets acquired and retained by Clock Restaurants from the date of said financial statement of September 30, 1956, to the date that Peterson takes possession of said Clock Restaurants are hereby likewise transferred, assigned and set over to Peterson.

* * * * *

(10) The parties hereto mutually agree that the transfer of the interest of Smith as a general partner in B. D. S. Company to Peterson shall be deemed and considered as transferred subsequent to the acknowledgment by B. D. S. Company of the receipt from Clock Restaurants of the rental of $305,481.17.

The agreement also states that there were certain pressing obligations of Clock Restaurants, for payment of which it was considered necessary that substantial deposits be made in the bank account of Clock Restaurants. The parties agreed that if Peterson advanced $146,000 for payment of the pressing obligations, taxpayer immediately would deliver possession of the Clock Restaurants. They further agreed upon arrangements for the opening thereafter of a bulk sales escrow for the consummation of the transactions contemplated by the agreement upon written demand by Peterson.[2] On or about November 1, 1956,

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[2] With respect to arrangements for immediate cash advances and the proposed bulk sales escrow, the agreement states (R. 421–423):

"(6) Peterson has analyzed the liabilities of Clock Restaurants as shown by said financial statement of September 30, 1956, and understands that there are presently outstanding approximately $30,000.00 of checks issued by Clock Restaurants

Peterson took possession of the Clock Restaurants which were the subject of the above agreement. (R. 37, 392–393, 423.)

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to its creditors and that no funds are in the bank account of Clock Restaurants from which said checks can be paid and that sufficient funds must be deposited in the bank account of Clock Restaurants to cover said checks forthwith. Peterson further understands that approximately $116,000.00 of taxes will become delinquent on the 31st day of October, 1956, which taxes represent payments due the United States Government for withholding and excise taxes, and to the State of California for unemployment and sales taxes. The parties hereto mutually understand and agree that there would not be sufficient time to consummate this transaction through a bulk sales escrow in time to pay the above referred to immediately pressing obligations, and that, accordingly, in the event that Peterson advances funds in the sum of $146,000.00 with which to pay said pressing obligations, that Peterson will concurrently therewith be delivered the immediate possession of all of the Clock Restaurants and the assets which are the subject matter of this agreement, and that thereafter upon the written demand by Peterson a bulk sales escrow will be opened for the consummation of the transactions contemplated by this agreement, and that if the creditors of Clock Restaurants prevent the consummation of said escrow by requiring immediate payment of their respective claims, Peterson will have the right and privilege of delivering possession to Smith or to any person entitled thereto of such of the assets being transferred by Smith to Peterson under this agreement which are subject to attack by said creditors and shall be relieved of any obligations or liabilities for the payment of said creditors' claims. As to any funds advanced by Peterson for the payment of any of the creditors of Clock Restaurants, Smith agrees to reimburse Peterson upon demand for repayment of said advances.

"As to any assets hereby transferred by Smith to Peterson which are not subject to attack by Smith's creditors, Peterson shall be entitled to keep and retain the same without the payment to Smith or to the creditors of Smith or of Clock Restaurants of any sum or other consideration therefor.

* * * * *

Taxpayer's adjusted basis for the computation of gain upon the assets which he sold to Peterson pursuant to their agreement of October 30, 1956, was $290,134.40. (R. 42, 424.) These same assets had a fair market value on October 31, 1956, of at least $603,-687.96 (R. 386–387, 424), the amount of taxpayer's liabilities which Peterson assumed as part of the consideration for the sale of the restaurants (R. 43, 424).

On taxpayer's 1956 federal income tax return the following statement appeared (R. 112–116, 424):

> Taxpayer sold remaining 12% interest in Clock Restaurants as of 10/31/56 based on a balance sheet as of September 30, 1956. The

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"(9) In the event that the bulk sales escrow hereinabove referred to is consummated and closed, Peterson agrees to indemnify Smith and hold Smith harmless from any loss or liability by reason of or arising out of the conducting of the business of Clock Restaurants by Peterson incurred subsequent to the date of the delivery of possession of said restaurants to Peterson. Until the closing of said bulk sales escrow, Peterson will operate as agent for Smith in the conducting of the business of said Clock Restaurants by Peterson, but Peterson does hereby agree to indemnify and hold Smith harmless from any loss or liability for any debts, obligations or liabilities incurred by Peterson in the operation of said restaurant business from and after the date that Peterson takes possession.

* * * * *

"(11) Smith hereby acknowledges receipt of the sum of $10,500.00 paid by Peterson for deposit in the bank account of Clock Restaurants and as part of the payment required to provide funds to cover outstanding checks of approximately $30,000.00 as referred to in paragraph (6) above, and Smith agrees that said sum of $10,500.00 has been or will be used solely for said purpose and that as a result thereof Peterson will be required to advance only the additional sum of $135,500.00."

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following Balance Sheet discloses all the assets and liabilities finally assumed by the purchaser. Since the taxpayer received only a non negotiable contractual obligation to pay the liabilities assumed and since no other consideration was received, the taxpayer elects to report the gain on the sale as a deferred payment sale. Income will be reported only when the amount of liabilities liquidated exceed the cost of the assets sold.

[Here there is set forth a list of assets totaling $284,983.09 and a list of liabilities totaling $603,687.96.]

Totals	$284, 983. 09	$603, 687. 96
		284, 983. 09
Excess of liabilities assumed over assets acquired		318, 704. 87

As of December 31, 1956 $142,493.39 had been paid on liabilities assumed.

On or about November 1, 1956, the taxpayer, B.D.S., and Peterson executed a document by which taxpayer assigned his interest in the "Master's Sublease" to Peterson and B. D. S. completely released the taxpayer from any further liability under that sublease. On the same date taxpayer, in writing, assigned to Peterson all of his interest in B. D. S. including his capital account in the partnership. Also on the same date the assignment was formally accepted by Peterson and formally consented to by the general and limited partners comprising B. D. S. (R. 39–40, 216–227, 245–254, 424–425.) At the execution of the October 30, 1956, sales agreement, Peterson advanced the amount of $150,000 which was used to discharge certain of the obligations of taxpayer subject to which ownership of the Clock Restaurants was transferred. (R. 389–390, 425.)

Peterson's understanding of the terms of the October 30, 1956, sales agreement was that by this agreement he was personally assuming the taxpayer's debts referred to in the agreement. (R. 387–388, 425.) By letter mailed on or about November 30, 1956, Peterson circularized the taxpayer's creditors in an attempt to gain their consents with respect to payment of existing accounts payable referred to in the sale contract and current accounts. The letter was couched in terms of prospective sale in pursuance of the Bulk Sales Act of California. Nearly all of these letters were returned with the acceptance of their terms by the creditors by December 31, 1956. No creditor pressed for payment of his account to such an extent that Peterson, under the terms of the sales agreement, returned to the taxpayer any of the assets purchased by him under the agreement. (R. 42, 285–308, 390–392, 394–397, 425.) During 1956, Peterson paid $326,443.08 on these debts and during 1957, $220,271.34 was paid either by Peterson or B. D. S., to which he had sold the Clock Restaurants during that year. (R. 43, 309–349, 425.)

During the period between November 1, 1956, and December 31, 1956, the Clock Restaurants were under the exclusive control and management of Peterson. Smith had nothing whatsoever to do with the operation of the restaurants subsequent to November 1, 1956. Peterson maintained books of account for his operation of the restaurants from and after that date. Peterson received the income and paid the expenses of the restaurants during the period from November 1, 1956, through December 31, 1956. He reported

the income from the restaurants for that period on his 1956 federal income tax return. (R. 392–393, 425–426.)

Peterson was not asked to and did not in fact account to the taxpayer for his operations of the Clock Restaurants from and after November 1, 1956. Neither Peterson nor his attorney ever demanded of the taxpayer that a bulk sales escrow be opened. A bulk sales escrow was never in fact opened in connection with the taxpayer's sale of the restaurant to Peterson. Peterson and his attorney felt that there was no need for a bulk sales escrow because they thought they had discovered all the liabilities of the business and also because, after taking possession, they contacted taxpayer's creditors and the creditors indicated they would not press for immediate payment of their accounts. (R. 393–395, 405–406, 426.)

On October 30, 1956, when the agreement between the taxpayer and Peterson for the sale of the Clock Restaurants was executed, the fair market value of Peterson's assets exceeded his liabilities by approximately $300,000–$400,000. (R. 397–398, 426.)

Peterson's sale of the Clock Restaurants to B. D. S. was in writing effective as of January 1, 1957. The sale was made subject to any remaining balance due upon the debts of the taxpayer referred to in the October 30, 1956, sales agreement, and Peterson acknowledged that by the sales agreement he had assumed those liabilities of the taxpayer. (R. 41, 255–256, 426.) B. D. S. then by letter circularized the tax-

payer's creditors, who were referred to in the October 30, 1956, agreement, in much the same manner as had Peterson in November, 1956. In each letter B. D. S. specifically assumed the balances payable on the indebtedness. All of the creditors accepted the terms set forth in these letters. (R. 43, 309–349, 426–427.)

On his 1956 income tax return taxpayer reported income from B. D. S. for the period April 1, 1956, to October 31, 1956. The taxpayer was not credited with any income or loss from B. D. S. subsequent to October 31, 1956, and the taxpayer did not report any income or loss from B. D. S. for any period after October 31, 1956. (R. 41, 427.)

On or about July 10, 1957, the taxpayer filed with the District Director of Internal Revenue at Los Angeles an application for extension of time for filing his 1956 income tax return. In this application the taxpayer made the following statement (R. 138, 428):

> It is impossible to accurately determine our taxable income, inasmuch as the selling price and terms of the sale of one of my business enterprises, made in December of 1956, are still in negotiation. We expect our attorneys to settle all details in the next 90 days.

On his 1957 income tax return, taxpayer stated that he sold the Clock Restaurants in 1956. On that return, the following schedule appears (R. 136, 428):

Sale of Clock Restaurants as reported in 1956 Return as a deferred payment sale

Description	*Acquired*	*Sold*	*Selling price*	*Cost or basis*	*Depreciation*	*Gain (loss)*
Paid in 1957	1952	1956	$220,271.34	----	----	$220,271.34

The sale by the taxpayer of the Clock Restaurants to Peterson was a closed and completed transaction in the calender year 1956. (R. 428.)[3]

The Commissioner assessed deficiencies in income tax against the taxpayer in the total amount of $85,865.67 ($66,551.05 for 1954, $7,835.30 for 1955, and $11,479.32 for 1956). By amendment to his answer in the deficiency proceedings in the Tax Court the Commissioner claimed an additional $5,735.29 in tax for 1956. (R. 418.) In the deficiency proceedings all issues were settled by stipulation except the question whether the taxpayer's gain from the sale of the Clock Restaurant is taxable in 1956. (R. 419.) The Tax Court held that taxpayer's sale of the restaurants was completed on October 30, 1956. (R. 432.) The Tax Court further held that the transaction in issue involved the substantial receipt of money by taxpayer and therefore that taxpayer realized gain in 1956 under Section 1001 of the Internal Revenue Code of 1954. (R. 434.)

SUMMARY OF ARGUMENT

On October 30, 1956, taxpayer owned the Clock Restaurants property, consisting of a chain of restaurants

[3] The books and records of the taxpayer, insofar as they pertain to the businesses operated by the taxpayer, including the operation of the Clock Restaurants which were the subject of the agreement of October 30, 1956, were kept on an accrual method of accounting, and the income or loss from these businesses is also reported on an accrual method of accounting. Nonbusiness items of income and deductions are reported by the taxpayer on the cash basis of accounting. Taxpayer's books and records pertaining to nonbusiness items of income and deductions were kept on the cash method of accounting. (R. 38, 427–428.)

and an interest in a limited partnership called the B. D. S. Company. On October 31, 1956, the Clock Restaurants property had an adjusted cost basis to taxpayer of $290,134.40 and taxpayer had liabilities of $603,687.96, which pertained to this property. The fair market value of the property was at least the amount of these liabilities, $603,687.96. Taxpayer sold the Clock Restaurants property to Robert O. Peterson pursuant to a memorandum agreement dated October 30, 1956, under which Peterson took the Clock Restaurants property subject to the applicable liabilities and thus made no direct cash payment to taxpayer but effectively relieved taxpayer of his substantial liabilities. It is undisputed that taxpayer realized substantial gain from this sale transaction. The only dispute is whether this gain was realized in 1956, in accordance with the Commissioner's determination which the Tax Court sustained, or in 1957 and later periods, as the taxpayer now contends.

The position of the Commissioner, sustained by the Tax Court, is that the sale transaction took place in 1956. The record shows that the terms of the memorandum agreement provide for a present sale in 1956; the parties intended that the sale take place in that year; and the actions of both parties with respect to the conduct of the business, treatment of their rights and obligations, and reporting of their income demonstrate that the sale was completed in 1956. The Tax Court's finding on this question is amply supported by the evidence and it is not clearly erroneous. Taxpayer's factual contention that his sale of the Clock Restaurants to Peterson was made

in 1957 or later is contrary to the findings of the Tax Court and the evidence in this case. There is no basis for a claim to deferral of tax on the ground that the sale did not take place in 1956.

Under Section 1001 of the Internal Revenue Code of 1954, gain from the sale of property is the "excess of the amount realized therefrom over the adjusted basis" and the amount realized is "the sum of any money received plus the fair market value of the property (other than money) received." The Tax Court held that taxpayer in substance received "money" in the amount of his indebtedness in 1956, and that therefore he is taxable in 1956 on the full amount of his gain from the sale of the Clock Restaurants. This holding is supported by the findings and evidence that as consideration for the Clock Restaurants property Robert O. Peterson, a solvent purchaser, assumed taxpayer's debt obligation in 1956. Peterson's assumption of the liabilities is established by the terms of the memorandum agreement, Peterson's testimony, taxpayer's own tax returns, and the actions of both parties.

Taxpayer's liability for tax as the result of the assumption of his indebtedness under the circumstances of this case follows from well-established principles. The Supreme Court has held (*Crane* v. *Commissioner,* 331 U.S. 1) that the "amount realized" upon a taxpayer's sale of property subject to a mortgage includes the amount of the mortgage as well as any additional consideration which the selling taxpayer may receive. Therefore, even if Peterson had not personally assumed taxpayer's liabilities, taxpayer

would have realized his gain from the sale subject to liabilties in 1956, the year of sale. But the evidence in the present case shows that Peterson did personally assume the taxpayer's liabilities with respect to the Clock Restaurants property. *A fortiori,* the applicable Supreme Court decision and other pertinent authorities support the holding of the Tax Court that taxpayer in this case realized gain from the assumption of his personal obligation by Peterson in 1956.

ARGUMENT

I. Taxpayer's sale of the Clock Restaurants to Robert O. Peterson was completed in 1956

The Tax Court's finding that the sale of Clock Restaurants by taxpayer to Robert O. Peterson was completed in 1956 (R. 428) is supported by the terms of the contract of sale (R. 420–423). Furthermore, the evidence discussed below, concerning the intention of the parties and their interpretation of the agreement and the objective conduct of the parties, shows that the sale was completed by about November 1, 1956, and after that time the Clock Restaurants in fact were owned and operated by Robert O. Peterson and not by the taxpayer. Accordingly, there is no basis for a claim (Br. 20, 21–29) to deferral of tax on the ground that the sale did not take place in 1956.

The terms of the memorandum agreement of October 30, 1956, provide for a present sale and transfer of the Clock Restaurants. Paragraphs (1), (2), (3) of the agreement each begin with the statement that the taxpayer "does hereby sell", assign and transfer or set over to Peterson specified assets. (R. 420–421.)

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The assets and liabilities which were the subject of the agreement consisted principally of the assets and liabilities disclosed on taxpayer's financial statement as of September 30, 1956 (with certain exceptions), the assets and liabilities accruing in the normal course of business from September 30, 1956, to the date Peterson took possession (about November 1, 1956), and taxpayer's interest in B. D. S. The assets and liabilities which were the subject of the contract were either ascertained or readily ascertainable on the basis of the contract description when Peterson took possession. (R. 140–141, 420–421.) The adjusted basis of the assets was $290,134.40 and the total amount of liabilities was $603,687.96. (R. 42–43, 424.) These stipulated amounts were reflected on taxpayer's 1956 federal income tax return. (R. 112–116, 424.) In the memorandum agreement (par. 5) the taxpayer agreed to indemnify and save Peterson harmless from any loss or liability by reason of any liabilities of taxpayer over and above those specified in the contract and totaling $603,687.96 (R. 421). Thus the agreement contains provisions establishing the amount and identity of the assets sold and the amount and identity of the liabilities subject to which they were sold and accepted. By its terms it is an agreement for the present sale, as distinguished from the future sale, of certain assets subject to certain liabilities.

The documents executed at or about the time of the October 30, 1956, memorandum agreement further show that there was a present sale of the Clock Restaurants at that time. It is stipulated that in accordance with the memorandum agreement taxpayer

transferred his interest in the B. D. S. Company to Peterson effective November 1, 1956. (R. 41.) The Assignment of Partnership Interest is dated November 1, 1956, and states that on that date taxpayer made and Peterson accepted the assignment and the remaining partners in B. D. S. accepted Peterson as a partner in place of Smith. (R. 246–247.) In his acceptance of the assignment, Peterson stated that he "agrees to hold Forest G. Smith, Jr. [taxpayer] harmless from any loss or liability resulting from * * * [taxpayer] being a partner in said limited partnership [B. D. S.]." (R. 247.) On the same date as the assignment an Amendment to Certificate of Limited Partnership of B. D. S. Company was executed by the partners (including both taxpayer and Peterson), eliminating the taxpayer as a partner and substituting Peterson. (R. 251–254.) Also in accordance with the memorandum agreement of sale (R. 421, par. 2), taxpayer assigned to Peterson his interest in the master sublease under which taxpayer was operating the restaurants. The Assignment of Master Sublease states that it is effective November 1, 1956, and that Peterson assumed all of the obligations of taxpayer as master sublessee and agreed to hold taxpayer "harmless from any and all liability thereunder arising on or after the effective date hereof" and that B. D. S. released taxpayer from all obligation or liability under the master sublease on or after that date. (R. 245.)

As the documents of the sale demonstrate, the parties intended and thought they had accomplished a completed sale on or about October 30, 1956. Taxpayer's

contemporaneous view of the transaction was reflected on his 1956 federal income tax return, where he stated (R. 112, 424):

> Taxpayer sold remaining 12% interest in Clock Restaurants as of 10/31/56 based on a balance sheet as of September 30, 1956.

On his return taxpayer further stated that as consideration "taxpayer received only a non-negotiable contractual obligation to pay the liabilities assumed" and he specifically listed "all the assets and liabilities finally assumed by the purchaser." (R. 112–116, 424.) In an application for extension of time for filing his 1956 income tax return, taxpayer stated that the sale had been "made in December of 1956" but requested the delay on the ground that the "selling price and terms on the sale" required further negotiation to settle all details. (R. 138, 428.) On his 1957 income tax return taxpayer reported income from the "Sale of Clock Restaurants as reported in 1956 Return as a deferred payment sale." (R. 136, 428.) On his 1956 return taxpayer reported income of $28,176.57 as his distributable net income from B. D. S. for the period April 1, 1956, to October 31, 1956. Taxpayer was not credited with any income or loss from B. D. S. after October 31, 1956, and he did not report any income or loss from B. D. S. for any period after that date. (R. 40–41, 111, 427.) Taxpayer did not testify before the Tax Court. Thus the evidence is that taxpayer intended to complete the sale of Clock Restaurants in 1956 and understood that by the October 30, 1956, memorandum agreement and the supplementary documents executed at or about the same time he had completed the sale.

The record supports the Tax Court's finding (R. 425–426) that during the period between November 1, 1956, and December 31, 1956, the Clock Restaurants were under the exclusive control and management of Robert O. Peterson. It is stipulated that on or about November 1, 1956, Peterson took possession of the Clock Restaurants property. (R. 37.) Peterson testified that he took control of the restaurants about November 1 and that taxpayer had nothing to do with the operation of the restaurants between that date and the end of 1956. During the last two months of 1956 Peterson received the income and reported and paid the expenses of the Clock Restaurants, he kept the books of the operation, and he was not asked to or required to account to taxpayer in any way during that period. Peterson testified that he reported the income on his 1956 tax return. (R. 393–394.) Also, Peterson's undisputed testimony establishes that at the signing of the October 30, 1956, sales agreement Peterson advanced $150,000 to cover certain liabilities of the Clock Restaurants and at about that time taxpayer transferred the bank accounts of the business to Peterson. (R. 389–390.) During November, 1956, Peterson or his employees telephoned or in some other way contacted creditors and obtained agreements as to how the liabilities of the Clock Restaurants would be paid off. (R. 390–391.) Letters of agreement were sent out, and before the end of 1956, written agreement had been received from all but a very few creditors. (R. 285–308, 391, 425.) Effective January 1, 1957, Peterson sold the Clock Restaurants to B. D. S. (R. 255–256, 426.) The evidence thus shows that during the

last two months of 1956 Peterson conducted the Clock Restaurants business as the sole owner.

The terms of the memorandum agreement of sale and associated documents, the intention of both parties as demonstrated by documentary evidence and oral testimony, and the objective conduct of the parties with respect to the control and disposition of the Clock Restaurant's assets after October 30, 1956, all show that on or about that date taxpayer sold the Clock Restaurants to Robert O. Peterson. Nevertheless, taxpayer contends (Br. 20, 21–29) that he sold the Clock Restaurants to Peterson in 1957, or later, rather than in 1956. Taxpayer asserts (Br. 21) that the terms of the memorandum agreement of October 30, 1956, provide for a bulk sales escrow and state that, until the bulk sales escrow is closed, Peterson would operate as agent for taxpayer in the conduct of the Clock Restaurant's business. Taxpayer's argument (Br. 21–29) is that the terms of the agreement are plain and require the conclusion that Peterson was an agent and taxpayer was the owner of the Clock Restaurants throughout 1956. This argument is inconsistent with the evidence in this case and contrary to the Tax Court's findings of fact. (R. 424–428.)[4]

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[4] Taxpayer contends (Br. 21–29) that the parole evidence rule precludes consideration of any evidence other than the terms of the memorandum agreement between taxpayer and Peterson. In *Stern* v. *Commissioner*, 137 F. 2d 43, in rejecting this argument, the Second Circuit stated (p. 46) that "the parole evidence rule only excludes proof varying a written instrument, where the issues are between the parties to it, and does not affect the right of the Commissioner, who was not a party, to go behind the written contract in order to discover the true facts." See, also,

The memorandum agreement of October 30, 1956, does provide for the opening of a bulk sales escrow "upon the written demand by Peterson." (R. 422.) The agreement further states that "In the event that the bulk sales escrow hereinabove referred to is consummated and closed * * * [Peterson agrees to indemnify taxpayer against loss or liability from Peterson's operation of the restaurants after delivery of possession to him]. Until the closing of said bulk sales escrow, Peterson will operate as agent for Smith [taxpayer] in the conducting of the business of said Clock Restaurants by Peterson [but Peterson agrees to indemnify taxpayer against loss or liability incurred by Peterson in the operation of the restaurant business after he takes possesion]." (R. 423.) The Tax Court properly interpreted the provision concerning a bulk sales escrow as an option granted to the purchaser which he could exercise or not as he saw fit. (R. 429.) The provision for a bulk sales escrow was to become effective only upon Peterson's written demand (R. 422), and no such demand ever was made (R. 394, 405, 426). The first sentence of paragraph 9 of the memorandum agreement, relating to Peterson's indemnification of taxpayer expressly applies only in the event a bulk sales escrow is consummated and closed. The provision that Peterson should operate as agent for taxpayer appears in the next sentence of the same paragraph and applies "Until the closing of said bulk sales escrow". (R. 423.) The

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Thorsness v. *United States*, 260 F. 2d 341 (C. A. 6th); *Landa* v. *Commissioner*, 206 F. 2d 431 (C.A. D.C.); *Scofield* v. *Greer*, 185 F. 2d 551 (C.A. 5th).

terms and organization of the agreement thus require that the bulk sales escrow be opened on Peterson's demand before he could become taxpayer's agent until the closing of the escrow. The terms of the agreement concerning the escrow are consistent with and supplement the remainder of the agreement, discussed above, providing for a present, rather than a future, sale of the Clock Restaurants.

The only purpose of a bulk sales escrow would have been to protect Peterson against the taxpayer's creditors. As the Tax Court points out (R. 429, 431), the bulk sales statute (Civil Code, 12 West's Annotated California Codes, Sec. 3440.1) protects the creditor of a bulk seller by nullifying any sale in fraud of creditors, but the statute does not affect the finality of a bulk sale between the seller and purchaser. *Jeffery* v. *Volberg,* 159 Cal. App. 2d 815, 324 P. 2d 964; *Bumb* v. *United States,* 276 F. 2d 729 (C.A. 9th).

Moreover, taxpayer's argument with respect to the bulk sales escrow is premised upon the contention (Br. 22, 24–25) that the contract plainly provides on its face for sale later than 1956, so there can be no resort to parole evidence. On the contrary, the terms of the contract itself, discussed above, clearly support the Tax Court's determination that the sale took place in 1956. If the contract is considered less than entirely clear on its face, other available evidence conclusively establishes that the sale of Clock Restaurants occurred in 1956. The testimony of Peterson, the tax returns filed by the taxpayer, and the complete control which Peterson exercised over the Clock Restaurants after November 1, 1956, all discussed above, sup-

port the Tax Court's finding (R. 428) that the sale of Clock Restaurants was made in 1956.[5]

II. Taxpayer's gain from the sale of the Clock Restaurants was realized in 1956

The further question in this case, premised upon the fact that taxpayer sold the Clock Restaurants to Peterson in 1956, is whether the taxpayer realized gain from the sale in 1956. Under Section 1001 of the 1954 Code (Appendix, *infra*), gain from the sale of property is the "excess of the amount realized therefrom over the adjusted basis" and the amount realized is "the sum of any money received plus the fair market value of the property (other than money) received." The Tax Court held (R. 433–434) that, since the purchaser, Robert O. Peterson, assumed taxpayer's obligations as the purchase price of the Clock

[5] Letters to creditors of the Clock Restaurants, which were couched in terms of prospective sale, were circulated by Peterson on November 30, 1956 (R. 42, 285–308); similar letters were circulated by B. D. S. in February 1957 (R. 43, 309–349); and notices of intended sale were filed and published in February 1957 (R. 44, 45, 412, 413). Taxpayer relies upon these letters and notices as evidencing an intention by the parties that the sale take place after 1956. (Br. 25–29.) The form Notice of Intended Sale was published in February 1957 on advice of counsel to protect the purchasers against any possible unknown creditors. (R. 406–407.) The few claims uncovered by this device were in part creditors of the taxpayer in connection with other businesses of his. (R. 407.) The letters and the notices necessarily were couched in future terms, for purposes of representation to creditors, in view of the terms of Section 3440.1 (a) and (b) of the California Civil Code. These actions, and the bulk sales statute to which they relate, as pointed out above concern only the relationship between a bulk sales purchaser and the creditors of the seller and have no bearing upon the finality of the sale between the purchaser and seller.

Restaurants property, taxpayer in substance received "money" in the amount of his indebtedness in 1956 and therefore is taxable in 1956 on the full amount of his gain from the sale transaction. The correctness of the Tax Court's holding, therefore, is supported by the factual determination that Peterson assumed taxpayer's indebtedness and, further, by the principle that assumption of a taxpayer's debt by a solvent purchaser for valid consideration in a sales transaction gives rise to the realization of gain under Section 1001 of the 1954 Code.[6]

The purchase agreement of October 30, 1956, considered as a whole, supports the Tax Court's fact determination (R. 433–434) that it provides for the sale of the Clock Restaurants' property by taxpayer in consideration for Peterson's assumption of liability for payment of taxpayer's indebtedness with respect to that property. The agreement does state (R. 421) that Peterson agrees to accept and pay for specified assets by taking them "subject to" certain liabilities. The

[6] With respect to the applicable principle see *Crane* v. *Commissioner*, 331 U.S. 1, discussed *infra*. The correctness of the rule may be illustrated by the example of an individual selling his residence subject to a mortgage. If the seller were able to defer reporting gain as realized until the purchaser paid off the mortgage to the third party lending institution in an amount greater than the seller's basis, often gain would not be reported until near the time the mortgage is paid off, years after the transaction really is completed. As the *Crane* opinion points out, the seller realizes a gain at the time of sale when the purchaser takes the residence or other property subject to the mortgage. The tax treatment is the same under the *Crane* decision, regardless of whether the purchaser personally assumes the mortgage, although the realization of income is even plainer than otherwise under circumstances like the present case where the purchaser assumed the seller's indebtedness.

agreement also states (R. 425, par. 5) that taxpayer agreed to indemnify and save Peterson harmless from any loss or liability by reason of any liabilities of taxpayer over and above those specified in the agreement, totaling $603,687.96. If Peterson was assuming no personal liability for these liabilities, there would be nothing from which to hold him harmless. The agreement also states (R. 421–422, par. 6) that, under certain circumstances (involving Peterson's possible exercise of his option to demand a bulk sales escrow), Peterson should be relieved "of any obligations or liabilities for the payment of [certain creditors' claims]." Here, too, if Peterson had no personal liability there would be nothing for taxpayer to relieve him of.

In addition to the terms of the agreement itself supporting the finding of the Tax Court, additional evidence of the intention of the parties and their actions shows that Peterson assumed the liabilities in question. Peterson testified (R. 387–388) that it was his understanding that the purchase price for the Clock Restaurants was the "assumption of the amount of the liabilities" and that he "assumed the liability * * * [he] was going to pay them." In accordance with this understanding, before the end of 1956 Peterson had circularized the creditors by letter and had entered into new agreements with them to discharge the indebtedness. (R. 42–43, 285–308, 425, 433.) In the agreement dated January 1, 1957, by which Peterson sold the Clock Restaurants to B. D. S., he repeatedly acknowledged that he previously had assumed the liabilities of taxpayer pertaining to the Clock

Restaurant property. (R. 255–256.) After it acquired the restaurants from Peterson, B. D. S. specifically assumed the unpaid balance owing to the various creditors. (R. 309–349.) Taxpayer himself did not testify before the Tax Court. But in his 1956 federal income tax return he expressly recognized that Peterson had assumed the liabilities as the purchase price of the Clock Restaurants property. (R. 112–116, 424.) On a balance sheet taxpayer listed "all the assets and liabilities finally assumed by the purchaser" and stated that he received a non-negotiable contractual obligation "to pay the liabilities assumed." (R. 112, 424.) He also reported the "Excess of liabilities assumed over assets acquired," though asserting that the tax should be deferred. (R. 116, 424.)[7]

The evidence then overwhelmingly supports the conclusion that by the purchase agreement of October 30, 1956, Peterson assumed the taxpayer's liabilities pertaining to the Clock Restaurants. It is undisputed that Peterson was solvent at the time and that the fair market value of his assets exceeded his liabilities by about $300,000 to $400,000. (R. 397–398, 426.) The liabilities were in fact paid and there is no contention to the contrary. (R. 43–44, 425.) Accordingly, by virtue of the October 30, 1956, purchase agreement taxpayer was effectively relieved of his indebtedness in issue by the assumption of the liabilities by a solvent purchaser of his assets. As the Tax Court points out (R. 433–434) the practical

[7] At the hearing before the Tax Court taxpayer's counsel also referred to the agreement as providing that Peterson "assumes" the liabilities. (R. 361, 362.)

substance of the matter is just the same as if in return for the Clock Restaurants' assets, Peterson had agreed to pay cash to taxpayer in the amount of the specified debts and taxpayer had agreed to use such funds for the discharge of the liabilities.

Taxpayer's liability for tax as the result of the assumption of his indebtedness under such circumstances is established by *Crane* v. *Commissioner,* 331 U.S. 1. In the *Crane* case the taxpayer had inherited real property which was subject to a mortgage. At the date of the testator's death the property was appraised at the exact amount of the mortgage. Later, the taxpayer sold the property subject to the mortgage and received only $2,500 in additional cash. The taxpayer never was personally liable for the mortgage and the purchaser did not assume the mortgage. Prior to the sale under an arrangement with the mortgagee taxpayer had collected the rents, paid operating expenses and taxes, and paid over the net rentals to the mortgagee, and she had claimed the appropriate deductions for interest on the mortgage and depreciation of the building. The Supreme Court held that the property which taxpayer acquired and sold was not the equity, as she claimed, but was the physical property itself undiminished by the mortgage. The basis for determining gain was the value of the property, undiminished by the mortgage, less appropriate adjustments. The Court further held that the "amount realized" on taxpayer's sale (defined under the Revenue Act of 1938, c. 289, 52 Stat. 447, Section 111(b), as under Section 1001(b) of the 1954 Code, as "the sum of any money received plus the

fair market value of the property (other than money) received") included the amount of the mortgage assumed by the purchaser as well as the relatively small amount of cash taxpayer received. The Court stated (331 U.S. 1, 13):

> * * * [Taxpayer] concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the "amount realized" within the meaning of § 111(b) [Revenue Act of 1938]. The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of "money" or "other property," in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole, and that the taxpayer was the "beneficiary" of the payment in "as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors."[8]

The Supreme Court further stated in *Crane* (331 U.S. 1, 14):

> * * * we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money

[8] See, also, *United States* v. *Hendler*, 303 U.S. 564; *Brons Hotels, Inc.* v. *Commissioner*, 34 B.T.A. 376; *Haass* v. *Commissioner*, 37 B.T.A. 948, all cited by the Supreme Court in the *Crane* opinion with respect to the quoted statement.

> from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

The principles of the *Crane* opinion were applied and discussed by the First Circuit in *Parker* v. *Delaney,* 186 F. 2d 455, certiorari denied, 341 U.S. 926. In *Parker* the taxpayer had held apartment house properties subject to mortgages, without assuming personal liability on the mortgage debts. After taxpayer had operated the property for several years during which he claimed depreciation deductions, when the mortgages were in default, by agreement the mortgagee banks took back the properties. No cash payment was involved. On the basis of the *Crane* opinion, the First Circuit held that taxpayer realized gain from the disposition of the property subject to the mortgagee, even though he never had assumed personal lia-

bility for the mortgage indebtedness.[9] See, also, *Woodsam Associates* v. *Commissioner,* 198 F. 2d 357 (C.A. 2d); *Fawsett* v. *Commissioner*, 63 F. 2d 445 (C.A. 7th), certiorari denied, 290 U. S. 641.

The *Crane* opinion and the consistent authorities discussed above support the conclusion that taxpayer realized gain on his disposition of the Clock Restaurants in 1956 regardless of whether Peterson assumed personal liability for taxpayer's indebtedness. While the *Crane* case involved the context of a disposition of property subject to mortgage indebtedness, there is no logical distinction between that transaction and the disposition of property subject to other valid indebtedness pertaining to the assets transferred. Moreover, the conclusion that in the instant case the taxpayer realized gain within the meaning of Section

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[9] In *Parker* v. *Delaney* the First Circuit stated (186 F. 2d 455, 458):

"If the amount of the unassumed mortgage in the Crane case was properly included in the amount realized on the sale, the amounts of the unassumed mortgages should be held to have been realized on the disposition in this case. * * * the property in the hands of appellant was relieved at the time of disposition of the mortgage liens and obligations. So far as appellant was concerned as owner these were paid even though he was not personally liable for them. The matter was so treated in the Crane case, 331 U.S. at page 13, 67 S. Ct. at page 1054. The added factor there, not present here, that boot was paid over and above the mortgage, is not material so long as the value of the properties was not less than the liens. Boot served to show this in the Crane case, but the payment of boot is of course not the only means of showing whether or not value is equal to or more than the liens on the property disposed of."

1001(b) of the 1954 Code from his sale of the Clock Restaurants in 1956 follows *a fortiori* from the *Crane* opinion. As demonstrated above, the evidence in this case amply supports the Tax Court's factual determination that in 1956 the purchaser, Peterson, assumed taxpayer's indebtedness with respect to the Clock Restaurants property. Taxpayer's realization of gain thus is demonstrated not only by the transfer of property subject to indebtedness, as in *Crane,* but also by the assumption of personal liability for the indebtedness by a solvent purchaser. Under these circumstances, the controlling authorities clearly support the Tax Court's holding that taxpayer realized gain from the assumption of his personal obligation by Peterson in 1956. *Crane* v. *Commissioner,* 331 U.S. 1, 13; *Parker* v. *Delaney,* 186 F. 2d 455, 458 (C.A. 1st).

Easson v. *Commissioner,* 294 F. 2d 653 (C.A. 9th), upon which taxpayer relies (Br. 42) does not concern the issue in the instant case. The *Easson* case involved specific provisions of the 1939 Code (Section 112) with respect to whether gain or loss is recognized when property, subject to indebtedness, is transferred to a corporation solely in exchange for stock of the corporation and the transferor satisfies requirements of control of the corporation immediately after the transfer. The opinion deals only with a specific nonrecognition problem under the 1939 Code and is based upon statutory provisions and concerns matters not involved in the present case.

Taxpayer's discussion of the legislative history of predecessors of Section 1001(b) of the 1954 Code and of various dictionary definitions of the terms "money" and "property" (Br. 32–39) contains no reason for reversal in this case. In the *Crane* case (331 U.S. 1, 13) the Supreme Court expressly rejected the argument that the term "money" and "other property" in this statute should be construed "in their narrowest senses." Taxpayer's attempted distinction of the *Crane* opinion (Br. 43–46) is without merit. In that case the Supreme Court interpreted the language of the predecessor of Section 1001, and that language is the same as the controlling statute here. In the light of the facts of this case the Supreme Court's interpretation of the applicable law in *Crane,* discussed above, supports the affirmance of the Tax Court's decision as involving an *a fortiori* situation.[10]

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[10] In view of its disposition of the case the Tax Court declined to decide whether the sale contract itself possessed a fair market value. (R. 434.) Taxpayer's argument before this Court that he obtained no rights with any fair market value in 1956 rests upon the testimony of Harold B. Lloyd. (Br. 40–41.) We note that with respect to the value of Peterson's obligation to pay taxpayer's obligations Mr. Lloyd testified that (R. 381), "* * * as an appraiser of physical assets, I can't ascertain or I can't determine that value." We submit that Mr. Lloyd's testimony as a whole (R. 377–382) is confused and of little value and would not constitute a basis for considering that a personal obligation of a man (Peterson) whose net worth is $300,000 to $400,000 has no fair market value.

CONCLUSION

For the foregoing reasons, it is submitted that the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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AUGUST 1963.

CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ——— day of August 1963.

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Attorney.

APPENDIX

Internal Revenue Code of 1954:

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment represent-

ing gain or profit in the year in which such payment is received.

(26 U.S.C. 1958 ed., Sec. 1001.)

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.1001–1 *Computation of gain or loss.*

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder.

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(26 C.F.R., Sec. 1.1001–1.)

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